DOW THEORY LETTERS INC.

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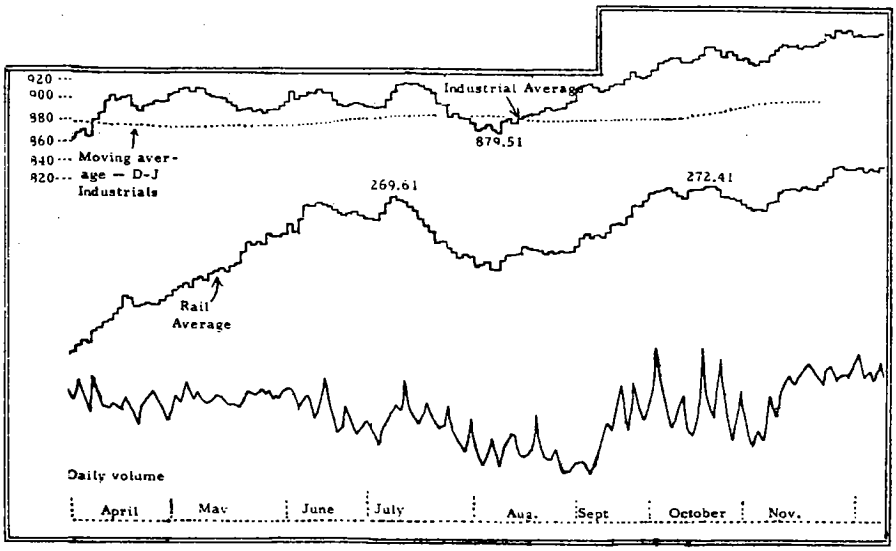
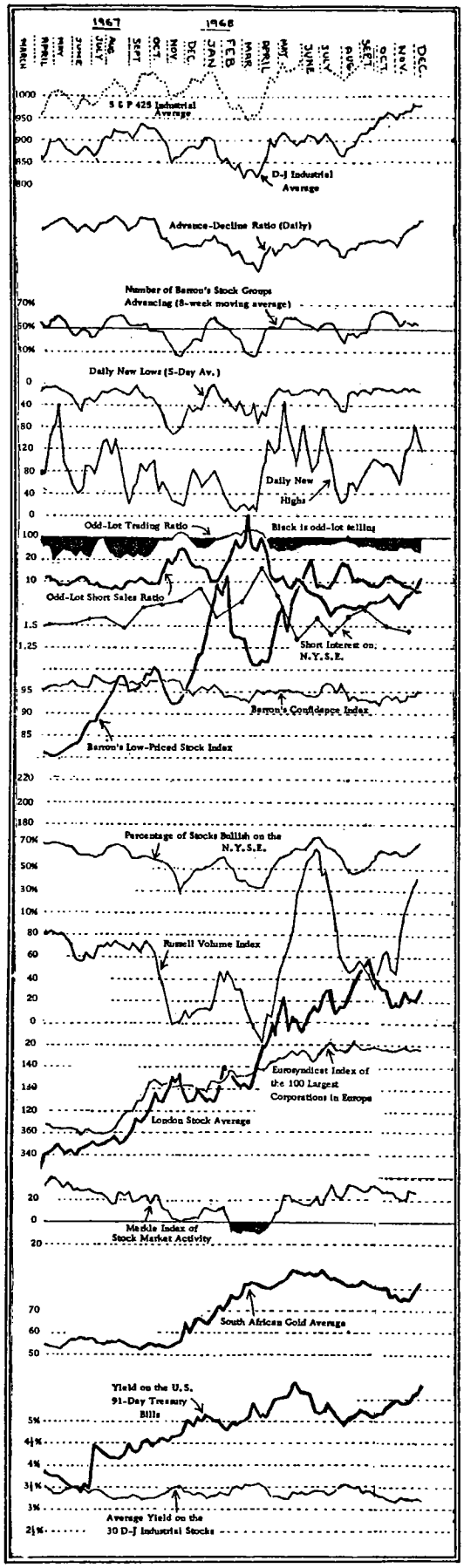
THE MARKET: There was a time a few years ago when I used to indulge in a little fantasy. "If I were only Secretary of the Treasury or Chairman of the Federal Reserve Board," I'd say, "I'm sure I could work the country out of this mess." I haven't been near that fantasy in many months. The mere thought of that fantasy scares me. The truth is, the monetary mess is bigger than ever now, and I wouldn't have the vaguest ides what to do "if I were king."

The Secretary of the Treasury is reduced to talking about more and more paper money, while the Federal Reserve Board has simply lost control of the situation. With inflation in the rampaging stage, interest rates are now going through the roof (see later section). If the Fed raises the discount rate and slackens the money supply (in view of the projected capital expansion boom), it will likely send the bond market into an even worse tailspin— and the economy with it. Reserve Board members speak privately about 10% as the average for wage increase demands next year. They see little evidence now of the hopes for business slowdown.

What to do? I don't know, and I don't think anyone else does either. At such times it is often best to wait and watch the market. If events continue as they are going, the next credit crunch will soon be upon us. A credit crunch would solve the inflation problem— and quickly, but it would create many other severe problems. The U.S. economic engine is now running at 120 miles per hour, and as I have said many times before, it is one thing braking a car going 30 M.P.H. and quite another braking a car going 120 M.P.H.

Last week Homestake Mining hurdled early 1968 highs to push to a new historic high (see later section). At the same time the price of gold in London rose to $42 per ounce, highest level since last July. I consider




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline Ratio (Daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Av.)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-Lot Short Sales Ratio
Short Interest on N.Y.S.E.
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of Stocks Bullish on the N.Y.S.E.
Russell Volume Index
Eurosyndicat Index of the 100 Largest Corporations in Europe
London Stock Average
Meddle Index of Stock Market Activity
South African Gold Average
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

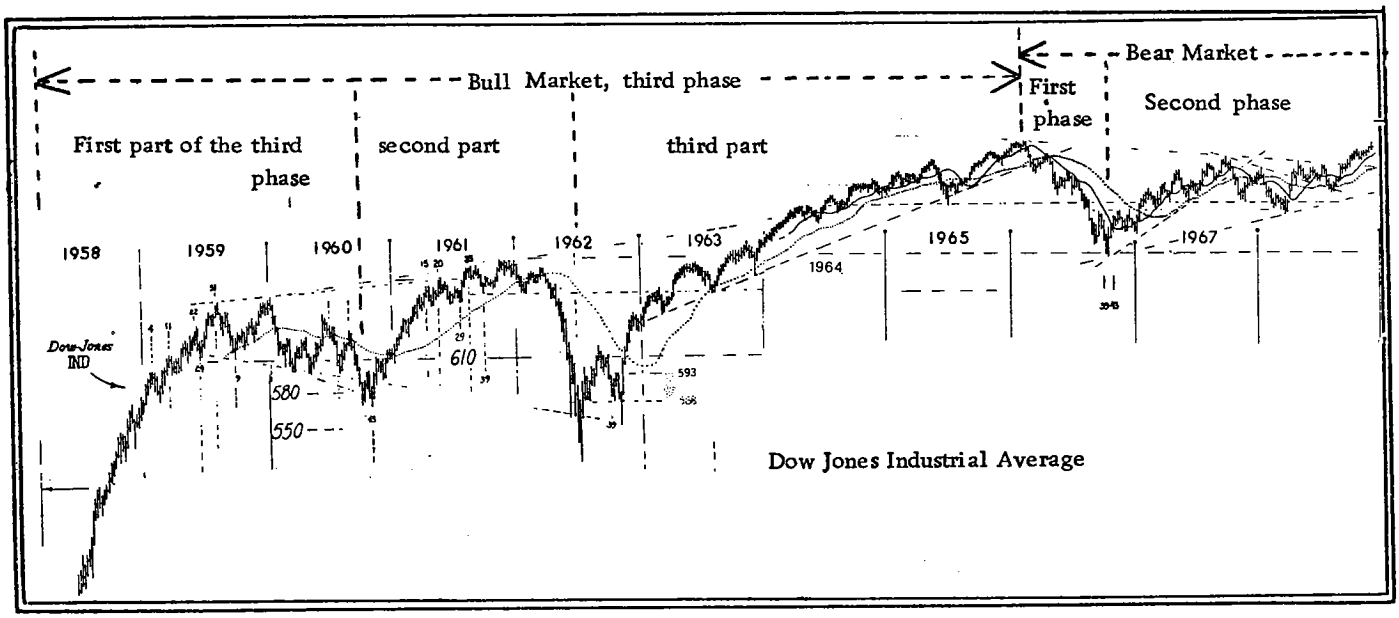
both events to be significant. The gold shares have been "shaken out" repeatedly during 1968. Every holder who was weak hearted or uninformed had his chance to run for the exits or sell on strength. Those who are left would seem to "know their stuff." Is Homestake telling us something about the resolution of the gathering crisis? With all the official "pooh poohing" of gold, it was no mean accomplishment for Homestake to rise to a new historic high. The gold shares may be telling us that the lid is about to be blown off the official $35 price for gold. The next few months could well tell the story, but the preamble is being written by the gold charts.

Meanwhile, with all Europe poised for devaluations during 1969 (the French franc, the Belgian franc, the Italian lire are all starting candidates), foreign capital is pouring into the U.S. and into the stock market. This is undoubtedly one of the "freak" forces pushing the stock market higher at this time.

* * * *

Over the past two weeks there has been a noticeable "churning effect" in the market. Although the massive volume continues (13 to 18 million shares per day), and although the speculation in individual stocks remains frenzied, the pleurality of advances over declines on advancing days has contracted sharply with many "up" days bringing in perhaps 50 to 100 more advances than declines. Under these conditions, the number of new lows recorded each day can be expected to expand, and this is what is happening. The market is now under greater technical strain than at any time in the past few months, and the huge volume is succeeding in bringing in fewer gains each day.

Over the last 22 trading days, the advance-decline ratio has advanced on 18 instances, and this means that we can expect a "counter-balancing" series of declining days over the near future. I feel the key to the market over the next few weeks (the short-term) will be the action of the advances and declines, and the relative ability of the advance-decline ratio to make any appreciable progress in the face of the current record volume.



THE BIG PICTURE: The accompanying chart shows the path of the Dow Industrials (weekly) since early 1958. I would like to analyze this market action in terms of bull and bear markets and phases.

The third or great speculative phase of the 1949-66 bull market began in October, 1957, at 419 on the Dow. By late 1958 new bull market highs were reached, and the Dow went on to register successive new highs during the remainder of 1958 and all through 1959. During the latter half of 1959 the steel industry embarked on the longest strike in its history. The strike was settled in January, 1960, simultaneously with the beginning of a severe market correction.

The correction terminated in October, 1960, whereupon the market headed up again. By early 1961 the Dow had again surged to new highs, amid the frothy, continuing third phase of the bull market. By mid-1961 it was obvious that this was a bubbling, "new issue" and science-oriented advance. Any stock with an -ionics or a -ific in its name was bought and run up. The moment of truth came in early 1962 as the market nose-dived into a break which made history by cutting mighty IBM in half. Many of the cheap, science stocks collapsed, a number never to come back again.

Again,the market started up, and again it was the blue-chip Dow issue which led the way. By late-1963 the old bull market highs were surpassed, and the market surged along all through 1964 and 1965. Thus it was seen that the third phase of the 1949-66 bull market was divided into three distinct movements, 1957 to 1960, 1961 to 1962, and 1962 to 1966. It was a third phase which lasted an unprecedented nine years, characterized by three distinct upward surges. Nothing like it had ever been seen in history.

What fed this gigantic third phase speculative movement? Basically, I feel it was the greedy monetary policy of the U.S. Government, a policy which resulted in accelerating inflation of prices and wages, an explosion in the U.S. money supply, a build-up in U.S. debts to titanic proportions, and the loss of a major part of the U.S. gold reserves. By 1966 the dollar was in shambles, and wave after wave of monetary crises marked the world scene from that point on.

At the 995.15 high of February, 1966, the Dow wavered, then broke. Despite continuing U.S. Government inflationary attempts, the market was badly battered, and the decline was not stemmed until late 1966. Then amid new and even wilder inflationary moves on the part of the U.S., the market started up in a recovery movement which was amazing for its persistence and force. Unlike the 1929-30 recovery (following the 1929 crash) which lasted only six months, the recovery following the 1966 low of 744.32 has lasted almost three years. It is still in progress.

As one veteran market analyst put it, on December 7, 1968, "Mass delusion remained intact this week and the market continued to respond bullishly to the mounting evidence of inflation running amok." Obviously, the public now believes that the only safety in the face of the U.S. inflation policy is in common stocks. Speculation is still feeding on speculation, and the stock market continues to live on hopes that somehow the world monetary situation will right itself.

With interest rates going through the roof, with almost every nation (with the exception of West Germany) in monetary trouble, with money-manipulations taking on the pattern of a frightening jig-saw puzzle, the market still flashes like a giant beacon for 25 million investors in the U.S.

As I see it, the first phase of the bear market began from the February, 1966 high of 995.15 on the Dow. The first phase ended rather soberly at the October, 1966 lows. The second phase of the bear market began at 744.32 on the Dow (October, 1966), and as of this writing the second phase is still in effect.

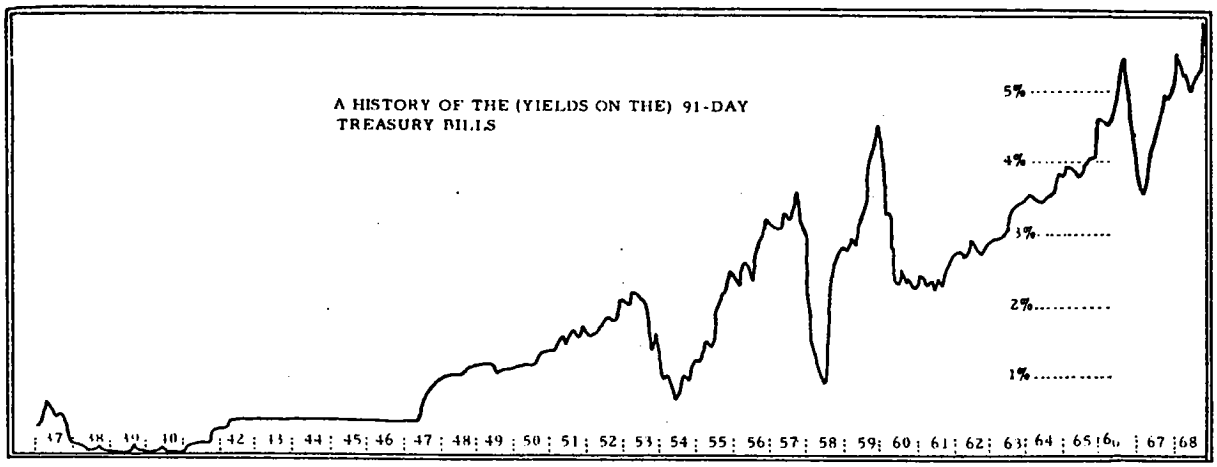
When the bear market began in early 1966 I wrote that historically the second phase of a bear market is the most deceptive one. I admit that at the time I did not expect anything as deceptive as the movement which we have witnessed since the 1966 lows. A few weeks ago the D-J Rail Average bettered the old bull market high of 274.49, recorded on August 4, 1967. As this is written the Dow Industrials are within 3% of their 1966 all-time high of 995.15.

I have repeatedly stated that we are in the most treacherous and deceptive second phase (upward correction) in all market history. I believe that by the time this second phase is over the Dow Averages and most stocks will be smashed to new lows (below the 1966 lows).

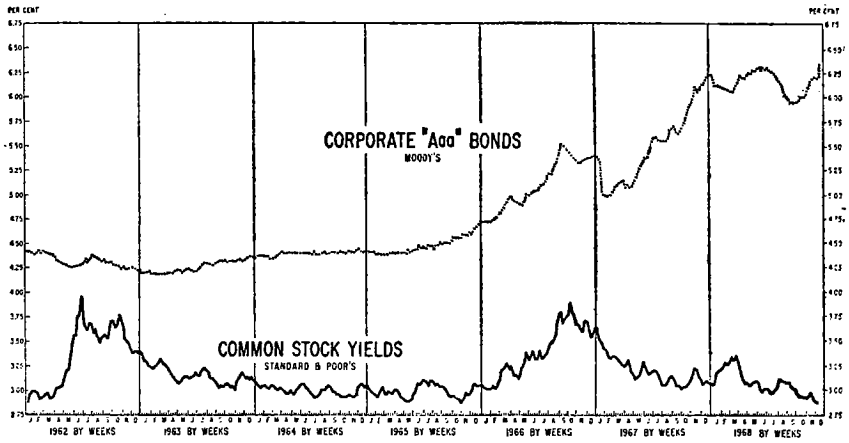
What if the Dow does succeed in confirming the Rails by pushing above its 1966 high? At this stage of the game, I would not consider such an upward penetration as signifying a new bull market or a reconfirmation of a bull market or a continuation of the 1949-66 bull market. I would consider it an historical aberration or "freak" that may occur once in a lifetime. It would be a final "fooler" in this frenzied, inflation-inspired correction of the 1966 decline.

CONCLUSION: Study the chart and note the fantastic length of the 1949-66 bull market's third phase (divided into three parts as shown). The first phase of the bear market was abnormally short (February to October, 1966), and therefore I expect the current second phase to be abnormally long, perhaps lasting another year or so. Following the termination of the second phase (which should take the Dow below the 1966 low of 744), I would expect the third or final phase of the bear market. That should come amid low volume, depressing business conditions and great pessimism on the part of investors. It is there that we should be presented with bargains in stocks comparable to the present extraordinary bargains in bonds.

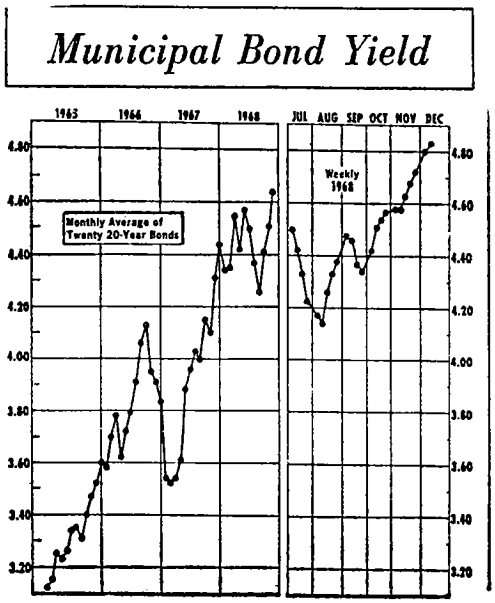
THROUGH THE ROOF: Interest rates are going through the roof. Last week the Municipal Bond yields (tax exempt municipals) rose to 4.80%, highest level in history (see chart, page 4). The bellwether Treasury 4¼ long-term bond



of 1987-92 dropped to historical lows below 80, to yield a whopping 5.82%. At the same time, 22 of the 32 listed long-term bonds sagged to yields of 5.5% or better, the greatest list of Treasury bond bargains in history.



The adverse yield spread (see chart) between Moody's Aaa-rated bonds and the Standard & Poor broad 500 Stock Average rose to 341 basis points, biggest spread in Wall Street annals. This unbelievable spread was caused by the yield on the S & P 500 declining to 2.88%, while the yield on the Moody's Aaa bonds rose to 6.27%!



Just as important was the sudden surge in the bellwether 91-day Treasury bill yield to last week's 5.96%. At that yield, the bills were 11 points above the record 5.85% recorded earlier in the year. The accompanying chart-history of the 91-day bills (chart on this page) puts the whole interest rate explosion in perspective.

I wrote many months ago that before this bear market was over, the U.S. Treasury was going to take on all comers for money. That money is needed by the Government to finance the biggest debt and the biggest budget (all financed at record rates) in world history. I believe we are nearing the rate and money war now.

There are currently over $20 billion in commercial bank certificates of deposit (or short-term loans) outstanding. Of that amount, about $5.3 billion are scheduled to fall due this month. Banks are worried, since the interest rates they pay on these C/D's are now at the legal limit. If money rates go up much further, the banks will be priced out of the market, they will not be able to provide corporations with money at rates which are competitive.

Meanwhile, with dividend payments and quarterly taxes coming due on or after December, Corporations are going to be drawing on their funds left with the banks. All of this could put new pressures on the money market and drive interest rates still higher.

The price of a business boom (with inflation) is rising interest rates. Every boom contains within it the seeds of its own destruction. One of the seeds of destruction in this business boom is rocketing interest rates. I warn all subscribers that just because high interest rates over the past year did not bring disaster, the implications of current new highs in debt yield should not be ignored.

Hamilton Bolton once wrote that the market can adjust, in time, to any given level of interest rates. But it can not take with equanimity a steady trend to higher interest rates. The trend is there on all the charts to see. It's up to the market now.

FLYING HOT MONEY: Hot money is money that will go anywhere at any time in search of (1) safety, (2) another ¼% in interest or (3) a speculation for a reasonably safe gain. The amount of hot money in the world today is unknown, but it is certainly in the tens of billions of dollars. As the world's monetary and political situation becomes more tenuous, an increasing amount of "cool" money becomes "hot," it is ready to move. In fact, it is even thought that the $12 ot $14 billions of monetary reserves now deposited in Britain (by nations which were once part of the British Empire) could easily become part of the world's huge hot money reservoir.

So violent and massive have the recent movements of hot money become that it is thought that 10 days before the British devaluation more pounds were sold than were in existence. Of course, such titanic selling creates a technically "oversold" situation, much as too much selling in the stock market creates an oversold condition.

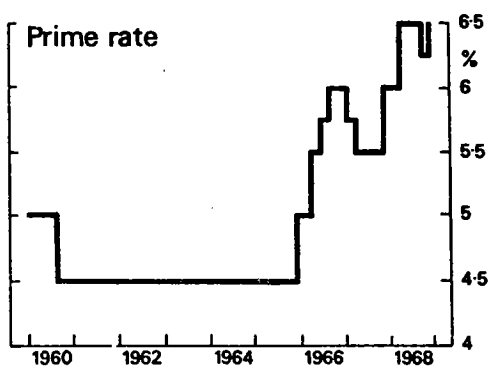
Currently, due to the French crisis, it is probable that the franc is oversold, and this is one of the reasons for recent strength in the franc. At the same time, the German mark is now probably overbought, and this could create some temporary weakness in the mark.

The recent movement of billions of dollars into Germany on rumors of a mark (upward) revaluation was not without its repercussions. Many American banks in recent years have relied on Eurodollars (dollars in Europe) to keep themselves in funds at home. But suddenly Eurodollars piled into Germany. Banks were forced to bid for the savings deposits of corporations at sharply higher rates. The rate on these corporate deposits jumped to 6¼% the legal limit, the same rate as the bank prime rate. The result was a rise in the prime rate to 6.5% (see chart), a move which pushed the prime rate up to its highest level in decades (compare the prime rate now with the same rate during the money crises over the past few years).

Anyone who thinks that the movement of hot money does not have an effect on the U.S. must now be about to do a bit of re-thinking. Meanwhile, another "mover" of hot money is looming over the horizon. This is the danger of war and military confrontation. Nothing sends hot money scurrying as fast as political danger, and the danger is increasing across the face of Europe.

Eliot Janeway, in his recent report, notes that Europe is becoming a political dynamite fuse. The reason is Russia's coming confrontation with Rumania and Yugoslavia. Since the Czech crisis, in fact, Janeway notes that Europe has not been the same, and he observes that "Europe is battening down the hatches in preparation for an across-the-board crisis of order and security — all the way from the streets of Paris to the hills of Yugoslavia and threatening to go back over to Berlin."

When European money is scared, it knows of two harbors of safety, Switzerland and the U.S. And much as Europe is afraid of what is happening to the U.S. dollar, it seems to be more afraid of what is occurring in Europe. In fact, large-scale European purchases of U.S. equities is one of the reasons for the recent strength in the U.S. stock market.



The loss of capital in Europe (in favor of the U.S. and Switzerland) could not come at a worse time. It is arriving at a time when import restrictions are rising in nation after nation, and at a time when the pressure is on for every nation to increase its respective foreign trade.

Meanwhile, the aftermath of the Great Franc Crisis is a series of austerity measures in both France and Britain. But the history of such measures is not hopeful. After all, the strength of a nation is measured

not only in reserves but also in the inherent competitive abilities of its businesses. Lower profits in France plus higher taxes and a decrease in government spending are not calculated to make French business look stronger. Austerity has not helped Britain in the 13 months since the 1967 devaluation, and, in fact, one of the rumors currently flying around the Continent is that Britain is in for another devaluation. Therefore, my opinion is that the austerity measures in France will at best buy time and at worst bring on a french recession.

Furthermore, the defense of the franc and the choice of austerity has put DeGaulle in a rather strategic position. DeGaulle refused to set off a monetary crisis by devaluing the franc by say 25%, but he still has the power to do so. By refusing to accept a token 10% devaluation as asked by the Group of Ten, DeGaulle allows himself political leverage to hold a 25% or 30% devaluation threat over the head of Europe and the U. S.

What will DeGaulle ask in return for keeping the plug in the boat? Ultimately, DeGaulle wants a gold standard (instead of the gold exchange standard) and a boost in the price of gold. With Nixon coming to office in a month, DeGaulle possesses an important weapon, and I personally believe he intends to use it. If the U.S. and the other leading nations do not go along with a boost in the price of gold, I would expect DeGaulle to play his trump hand, a whopping devaluation of the franc. By not accepting a minor 10% devaluation, DeGaulle retained his political trading power.

Incidentally, I am still scrutinizing all statements from Nixon and his team in regard to the pricing of gold. So far (as mentioned in a previous Letter), I have not seen a word from a Nixon man which implies that the price of gold is immutable. As the movements of hot money become more and more violent, as the monetary crises become more and more frequent, it becomes increasingly obvious to thinking men that the present $35 price for gold must change.

Also obvious is the fact that currency dislocations and panic are at the point where they are affecting world prosperity. Furthermore, the measures taken so far to "fix" things have avoided the fundamental issue of gold.

The whole picture was put in perspective last week by Sydney Gampell, Financial Editor of the huge Reuters agency: "As the rigidities of the present currency system literally seized up, more flexibility is advocated by many, including some of the men who drew up the Bretton Woods scheme, if not by all of that scheme's present custodians. Each of its crises is progressively worse than the last, and worse than was believed possible, and not so bad as the expectations of the next one. Current tinkering is as widely derided as a poultice for an earthquake or an aspirin for cancer."

In view of this kind of thinking, we should not take the view that investors are speculating in gold shares, what they are doing is seeking the safety of placing part of their capital in gold (or gold shares) and in so doing assuming a hedge position in the only commodity which has not been raised (officially) in price in over three decades.

MARKET LABORATORY:

As the strain of surging interest rates, vicious money competition, inflows of foreign money and a dozen other items press on the stock market, it becomes obvious that the market is a flying jig-saw puzzle. Pictured here are three of the early-1968 glamors, and it is immediately obvious that erratic trends are the order of the day. Glamor is no longer a "sure money maker" in this market, nor is blue-chip status, or any other analytical gimmick. It's becoming an every-man-for-himself market as the search for the winner becomes more intense and more difficult. Meanwhile, our old friend Homestake (leading U.S. gold mining equity) has pushed steadily to new all-time highs. The highly bullish pattern of successively higher highs and successively higher lows continues to hold intact in HM. (Stock Charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).